

Allowance Method: Aging Receivables

by Sophia



WHAT'S COVERED

This lesson will cover the allowance method using aging receivables.

Our discussion breaks down as follows:

1. Uncollectible Accounts: A Review

An uncollectible account is an accounts receivable that is unpaid and is written off as bad debts expense.

We need to recognize and record these uncollectible accounts and the amounts that are expected not to be collected from credit customers. So, if any customers made purchases on credit and we don't expect to collect on those sales, we need to record those uncollectible accounts.

Now, the allowance method is required for financial reporting. It helps us to achieve matching, so that we can match our bad debts expense with the period in which the uncollectible sale took place.

We can determine uncollectible accounts by using some common methods to help us calculate our uncollectible accounts, or our allowance.

We can use:

- Percentage of net credit sales
- Percentage of receivables
- Aging receivables.

Today we're going to focus on aging receivables.

2. Aging Receivables

Aging receivables refers to estimating percent of accounts receivable for which payment will not be collectible. In other words, we're using our accounts receivable to create our estimate.

This estimate can be made using industry standards, past experience, or any other logical method that management has determined.

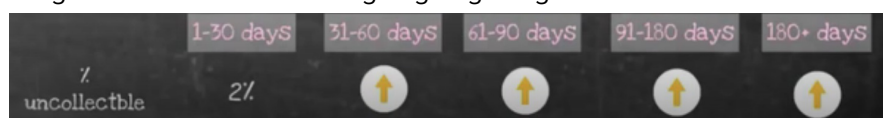
The relationship that is emphasized in aging receivables, because we're focusing on accounts receivable, is our balance sheet relationship. Again, we're using accounts receivable to help us determine our allowance for uncollectible accounts, which are both balance sheet accounts.

The existing balance in the allowance account is considered, so we need to take into consideration any existing balance that we already have in our allowance account.

Under the aging receivables method within the allowance method, the accounts receivable are categorized based on the total days outstanding. This means we can categorize our accounts receivable into these time periods:

- 1-30 days
- 31-60 days
- 61-90 days
- 91-180 days
- 180+ days

Now, the estimated percentage of our uncollectible accounts increase as the days outstanding increase. Therefore, for instance, if we start with 2% in that first time period, that 2% is going to increase the farther out we go from that due date. It's going to get higher for our older receivables.



3. Calculating Aging Receivables: Example

Let's do a demonstration of calculating aging receivables by performing an example, which will help us to understand how we can use aging receivables to calculate our allowance.

Here is an aging schedule of all of our accounts receivable. An aging schedule is where we summarize all of our accounts receivable for each customer, then we categorize it into the time period in which that accounts receivable is outstanding.

Aging Schedule						
	Balance					
Customer	1-30 days	31-60 days	61-90 days	91-180 days	180+ days	Total Balance 12/31/12
Customer A	\$10,000	\$5,000				\$15,000
Customer B		\$7,000	\$3,000			\$10,000
Customer C	\$1,000			\$2,000		\$3,000
Customer D			\$1,000	\$1,000	\$1,000	\$3,000
Customer E				\$5,000	\$5,000	\$10,000
Total	\$11,000	\$12,000	\$4,000	\$8,000	\$6,000	\$41,000

For example, Customer A has a \$10,000 balance that is 30 days or less outstanding and a \$5,000 balance that is between 31 and 60 days outstanding.

Now we need to look at the percent of those accounts receivable that we estimate to be uncollectible. As you can see below, that percentage grows over time as we extend out to the category of receivables that have been outstanding for over 181 days.

Aging Schedule						
	Balance					
Customer	1-30 days	31-60 days	61-90 days	91-180 days	180+ days	Total Balance 12/31/12
Customer A	\$10,000	\$5,000				\$15,000
Customer B		\$7,000	\$3,000			\$10,000
Customer C	\$1,000			\$2,000		\$3,000
Customer D			\$1,000	\$1,000	\$1,000	\$3,000
Customer E				\$5,000	\$5,000	\$10,000
Total	\$11,000	\$12,000	\$4,000	\$8,000	\$6,000	\$41,000
Uncollectible (%)	2%	5%	15%	35%	85%	

Next, we take those percentage estimates and we calculate the total uncollectible balance.

Aging Schedule						
	Balance					
Customer	1-30 days	31-60 days	61-90 days	91-180 days	180+ days	Total Balance 12/31/12
Customer A	\$10,000	\$5,000				\$15,000
Customer B		\$7,000	\$3,000			\$10,000
Customer C	\$1,000			\$2,000		\$3,000
Customer D			\$1,000	\$1,000	\$1,000	\$3,000
Customer E				\$5,000	\$5,000	\$10,000
Total	\$11,000	\$12,000	\$4,000	\$8,000	\$6,000	\$41,000
Uncollectible (%)	2%	5%	15%	35%	85%	
						Total Uncollectible Balance
Uncollectible (\$)	\$220	\$600	\$600	\$2,800	\$5,100	\$9,320

For example, the uncollectible dollar amount of \$220 was calculated by taking the \$11,000 balance that is 30 days or less outstanding, and multiplying it by the 2% percentage estimate.

We perform the same calculations down the line to arrive at the total estimated uncollectible allowance of \$9,320.

Now that we know that our total allowance is \$9,320, let's look at a couple different scenarios for recording that entry into our financial system.

➔ **EXAMPLE Scenario 1:** First, let's make an assumption that there is no balance in our allowance for uncollectible accounts. If there's no balance in that account, our journal entry looks like this:

						Total Uncollectible Balance
Uncollectible (\$)	\$220	\$600	\$600	\$2,800	\$5,100	\$9,320
Scenario 1: Assume there is no balance in 'Allowance for Uncollectible Accounts'						
Journal Entry:	Bad Debt Expense			\$9,320		
	Allowance for Uncollectible Accounts				\$9,320	

We would have a debit to bad debt expense and a credit to our allowance for uncollectible accounts, for the full allowance that we calculated doing our aging receivables.

➔ **EXAMPLE Scenario 2:** In this scenario, we will assume there is a \$2,000 balance in the allowance for uncollectible accounts. How does this affect our journal entry? We still debit bad debt expense and we credit allowance for uncollectible accounts, but you'll see that the amount of that entry is \$7,320.

						Total Uncollectible Balance
Uncollectible (\$)	\$220	\$600	\$600	\$2,800	\$5,100	\$9,320
Scenario 2: Assume there is a \$2,000 balance in 'Allowance for Uncollectible Accounts'						
Journal Entry:	Bad Debt Expense			\$7,320		
	Allowance for Uncollectible Accounts				\$7,320	

This is because we already have a \$2,000 balance, so in order to get to a balance of \$9,320 in that allowance account, we only need to increase it by \$7,320.



SUMMARY

We began today's lesson with a **review of uncollectible accounts**, which are recorded using the allowance method. You may recall that the allowance method is required for financial reporting. We learned about using the **aging receivables** method within the allowance method. Lastly, we explored an **example of calculating aging receivables** in order to calculate our allowance.

Source: Adapted from Sophia instructor Evan McLaughlin.